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C O N F I D E N T I A L SECTION 01 OF 02 BEIJING 004105

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E.O. 12958: DECL: ARRIVAL IN WASHINGTON
TAGS: EFIN ECON KPAO PREL CH
SUBJECT: CHINA/G-20 SUMMIT: OBJECTIVES AND BACKGROUND

REF: 1) STATE 114420 2) BEIJING 04084 3) BEIJING 04062

Classified By: CDA Daniel Piccuta for reason 1.4 (B)(D)

¶1. (U) To respond to the questions posed in ref 1 request, Post has drawn from a variety of sources, including publicly available statements, private conversations with officials (see ref 2 and 3), and knowledge of Chinese approaches to previous multilateral engagements.

¶2. (C) BEGIN ANSWERS

¶I. Key Objectives and Priorities
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a. What are China's likely objectives in attending the summit?

China appears to have several broad (at least partially competing) objectives:

1) Expand its international role and affirm its position as a major economy;
2) Ensure that any cost China is asked to bear connotes commensurate influence;
3) Advance China's goal of positioning itself as a representative of the developing world in these discussions;
4) Encourage measures to promote global growth to sustain China's exports; and
5) Protect China's overseas investments.

b. Are there particular desired outcomes that China hopes to attain?

China's economic team is meeting to develop specific proposed outcomes. Based on China's likely objectives, we feel China may press for the following outcomes:

1) A greater voice for China in both discussion of the crisis and in any new institutional arrangements (China's Sherpa has already initiated calls to all 19 of his counterparts);
2) A commitment to progress by consensus to ensure China can block any action that it perceives would pose a threat to its domestic economic policies;
3) Actions to prevent developed countries from shifting the costs of the crisis onto emerging markets; and
4) For developed nations to back China's overseas investments in financial institutions and GSE assets.

c. What recommendations might China make or accept?

1) Reform of international economic financial institutions to give developing economies, and China, a role more commensurate with their roles in the global economy.
2) Creation of institutions or actions that protect developing countries' interests.

3) Acceptance of China as the voice of the developing world.

Beyond these recommendations, China could conceivably accept:

Establishment of an international consultative body that would make consensus recommendations to G-20 governments but would have no coercive ability.

China will resist:

Arrangements that would infringe on China's freedom to adopt economic policies it deems appropriate.

II. Key Concerns
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d. What are China's greatest concerns about the current financial crisis?

China's greatest concerns are the impact of falling external demand on its exports, resulting in slower economic growth and higher unemployment. Also, China's central bank is a major holder of U.S. Treasury and agency securities, and its sovereign wealth fund holds large stakes in a few U.S. financial institutions. They are concerned about the long-term commitment (into the next U.S. administration) of the USG to guarantee these institutions' liabilities.

e. What issues are likely to be foremost on the leader's mind?

China wants to limit the impact of the crisis on its economic growth, unemployment, and social stability.

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III. Impact of the Financial Market Crisis on the Financial Sector
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f. What are the most important impacts of the financial crisis on China's financial sector?

China's mainland financial sector has emerged from the initial phases of the financial crisis relatively unscathed. China Investment Corporation (CIC), Chinas' sovereign wealth fund, had a USD 5.4 billion investment in the Reserve Primary money market fund frozen due to the bankruptcy of Lehman Brothers. China also has approximately two-thirds of its USD 1.9 trillion in foreign exchange reserves invested in U.S. treasuries and agency bonds. Domestic lending to foreign banks in the interbank market has been affected, as Chinese banks have sought to reduce perceived counterparty risks following Lehman's bankruptcy.

IV. Actions Taken to Address the Financial Crisis
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g. What initiatives has China taken in response to the financial crisis?

The Chinese government has begun to ease monetary policy by easing credit quotas for certain sectors, and lowering reserve requirements and administered interest rates. It has announced some modest fiscal stimulus through spending increases and tax cuts targeted at politically sensitive sectors (i.e. labor intensive exporters, farmers). It has also eased certain prudential regulations on residential real estate lending due to concerns about a weakening property sector. To address the liquidity needs of foreign banks, the central bank has allowed them to borrow foreign currency from their headquarters on a temporary basis. Beijing regulators have modified trading rules and reduced transaction taxes to support the stock market.

¶V. Current Economic Situation/Near-Term Outlook
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h. How has the outlook for growth, inflation, current account, exchange rate, budget deficit changed?

While overall growth has slowed, the economic trajectory still appears headed for a soft landing and the financial sector appears fundamentally sound.

Downside risks have risen, however, and senior leaders are focused on maintaining rapid growth. Slower growth may reduce (albeit on a temporary basis) some of China's growing macroeconomic imbalances, such as excessive investment, high inflation and a large current account surplus, although some of the structural measures (VAT reductions on certain exports and purchases of capital goods) meant to counter cyclical slowdowns could set back rebalancing. China's headline inflation rates have declined substantially, and excess productive capacity (from the investment boom of the last several years) and falling commodity prices may exert deflationary pressure over the next year. The large current account surplus should decline moderately, as declining exports are partially offset by lower import demand and prices. Foreign direct and portfolio investment will decline as risk-averse investors repatriate money, helping to slow the large and excessive buildup in foreign exchange reserve. China is well positioned to inject monetary and fiscal stimulus if growth slows further. China's central bank has ample scope to inject liquidity by unwinding the large sterilization operations it has taken in past years. Given China's low public debt to GDP ratio, fiscal stimulus is unlikely to raise concerns about fiscal sustainability. Banks are liquid and reasonably well capitalized, though they are likely to be less willing to lend as perceived credit risks rise. Given the sharp appreciation of the RMB on a trade weighted basis, its appreciation against the dollar has recently plateaued.

END ANSWERS

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